

# Part I : The Experiences of Asian Developing Economies under Globalization: Institutional Reform and Industrial Restructuring : Chapter 1: The Case of South Korea: 'Selection and Growth and Companies'

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## **PART I**

**THE EXPERIENCES OF ASIAN DEVELOPING  
ECONOMIES UNDER GLOBALIZATION:**

**INSTITUTIONAL REFORM AND  
INDUSTRIAL RESTRUCTURING**

## **CHAPTER 1**

### **THE CASE OF THE SOUTH KOREA: SELECTION AND GROWTH OF COMPANIES**

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#### **1. BACKGROUND OF THE ECONOMIC CRISIS AND IMF LENDING PROGRAM**

##### **1.1 Background of the Crisis**

On January 23, 1997, Hanbo Steel, the core company of the Hanbo Group, failed to honor its bills, facing financing difficulties after years of overinvestment. Hanbo Steel, along with a civil engineering firm within the corporate group, filed with Seoul District Court for legal receivership, seeking a third-party sponsor for its reconstruction. The Hanbo Group's debt-equity ratio was 752% in 1995. On March 18, meanwhile, Sammi Specialty Steel, the core company of the Sammi Group, and Sammi also filed an application for legal receivership. The Sammi Group has a debt-equity ratio of as high as 3,420% for 1995.

A spate of bankruptcies of corporate groups saddled South Korea's banks with massive nonperforming loans, and international confidence in these banks rapidly plummeted. Concerned about potential funding problems at banks, the Bank of Korea, the country's central bank, announced an emergency aid package of \$1 billion for Korea First Bank and other banks. In order to help encourage an inflow of foreign capital, the South Korea also raised the ceiling on foreign investment in the stock market by 3 percentage points to 23% during the first half of 1997.

The Korea Association of Banks, for its part, arranged to conclude an agreement to help prevent the dishonoring of bills to step a chain of corporate group failures. The voluntary agreement called for financial institutions (excluding non-banks) to extend the repayment deadline of their lending to companies for two months, during which they would examine and decide whether there is any chance of borrowers being able to reconstruct themselves. Bills and checks issued by companies made subject to this agreement were not

treated as dishonored even when they actually failed to honor them because banks suspended the processing of their bills and checks during the examination period.

On April 21 of that year, liquor and distribution group Jinro went virtually bankrupt after becoming the first company to be screened under the bankers' bill-bouncing prevention agreement. In May, Daeno, the textile- distribution group that owned Midopa Department Store, became the second to be handled by the accord. In July, the Financial Supervisory Commission (FSA) announced a list of 63 corporate groups with 250 billion won or more of borrowings and debt guarantees as potential candidates to be subjected to the bill-dishonoring prevention accord. The list included many of the South Korea's top big groups, including Samsung and Hyundai.

As explained above, when a company is made subject to the bill-dishonoring prevention agreement, the clearing of its bills is suspended, making it impossible for non-banks, which stay out of the accord, to collect their lending. So, non-bank lenders tried to recover their funds from shaky companies before the agreement was made applicable to indebted firms.

A report by the Samsung Economic Research Institute that Kia Motors Corp. is facing financial difficulties spurred non-banks' frantic efforts to collect loans to the troubled automaker. Kia Motors' total debts had climbed to some 9,470 billion won (about \$10 billion at the July 1997 exchange rate of 892 won to the U.S. dollar), chiefly because of large borrowings for facility investment at Kia Steel. The virtual bankruptcy of Kia Motors on July 15 was triggered by non-banks that scrambled to recover their money lent to the group before it came under the bill-bouncing prevention agreement. Failures of corporate groups continued unabated. In October, New Core Group in the distribution sector and furniture manufacturer/seller Baroque Group became insolvent, making the collapses of corporate groups with huge debts only a matter of time.

In the wake of the string of corporate group bankruptcies, four of the 15 major banks reported losses for the first half of 1997. Of the top-tier six banks, two were in the deficit. International banks that provided short-term funds (of less than one year of maturity) to the South Korean financial institutions refused to roll over the loans and began collecting them. The South Korea's corporate groups borrowed short-term funds from banks for equipment investment and effectively turned short-term borrowings into long-term debts through refinancing arrangements. They became insolvent because this fund-raising method was rendered unworkable. In the South Korean economy that kept expanding almost uninterruptedly until then, the fund-raising scheme of borrowing short-term funds at relatively low interest rates and then turning them into long-term borrowings through refinancing arrangements was advantageous to both banks and corporate groups of South Korea. As of November 1997, the ratio of short-term funds to total external debts stood as

high as 55.0%. As the South Korean companies funded their capital spending programs with borrowings, their debt-equity ratio rose to extremely high levels. This way of fund-raising proved to be the key to the South Korea's rapid economic growth, but also its Achilles' tendon.

## 1.2 Conditionality of IMF Loans

On December 3, 1997, the South Korean government accepted terms and conditions for the loan package of \$55 billion provided by the International Monetary Fund (IMF) and other international lending institutions as well as major countries to avert the country's financial crisis. The package consisted of \$21 billion from the IMF, \$10 billion from the World Bank, \$10 billion from Japan, and \$14 billion from the Asian Development Bank and others. The IMF loans comprised \$5 billion in two-year and three-year maturities and the new facility of \$16 billion, making it larger than the package put together to cope with the Mexican currency crisis.

The conditions of the IMF loan package (see Table 1-1) called, first of all,

**Table 1-1 Principal Terms of the IMF Loan Package**

- \* Hold down the current account deficit to no more than 1% (some \$5 billion) of GDP in 1998 and 1999, and also hold down the annual GDP growth rate to 3%.
- \* Hold down the inflation rate to no more than 5% a year.
- \* Balance the budget or post a small fiscal surplus.
- \* Increase tax revenue. Revenue-raising methods to be considered.
- \* Strengthen the employment insurance system, promote the redeployment of human resources, and increase mobility in the labor market.
- \* Open the capital market early to foreign competition.
- \* Suspend business of nine financially troubled merchant banks. Rescind their business authorization in March 1998.
- \* Allow the acquisition of financially strained banks after giving them a chance to improve management until the first half of 1998.
- \* Allow interest rates to go up from 18% to 20%.
- \* Enhance the transparency of corporate finance by introducing the accounting system based on international standards.
- \* Advance the removal of restrictions on imports of specific items (import curbs on Japanese products), originally scheduled for implementation in stages until 1999.

Source: Prepared by the author from reports on the December 4, 1997, editions of the *Dong Ah Ilbo*, the *Nihon Keizai Shimbun*, the *Asahi Shimbun*, etc.

for the South Korea to keep its annual current account deficit to no more than 1% of the country's gross domestic product (GDP). This requirement meant the South Korea should rein in its economic growth rate. The IMF also required the South Korea to accelerate the opening of its financial markets to foreign investment with the aim of raising funds necessary to repay debts from overseas. Drastic reforms of the country's economic structure were also among the IMF terms. Specifically, they called for reform of the financial sector heavily saddled with nonperforming loans, reform of the corporate sector that got into the muddle after years of overinvestment with easy borrowings, and reform of the labor market to encourage greater mobility of labor.

## **2. PHILOSOPHY OF PRES. KIM DAE JUNG**

President Kim Dae Jung, upon his election in December 1997 without waiting for the official inauguration in February 1998, immediately launched energetic efforts to implement reform measures stipulated under the terms of the IMF loan package.

The South Korea has achieved rapid economic growth with the government-initiated development formula. The growth was made possible under the government-devised development program, which was carried out by corporate groups handpicked by the government, with the aid of cheap financing and a variety of other preferential measures directed at them. Big corporate groups cited in this paper expanded their business operations by winning big-ticket projects through heavy lobbying for the government's favors. This pattern of economic growth distorted the country's economic structure and provided a hotbed of people's grumbling. The support base for President Kim was the people who had been given the cold shoulder in the previous pattern of fund allocation. So, expectations were high that he could correct the past distortions and democratize the country's economic system. President Kim could not have hoped for better support than the IMF-imposed conditions in pushing the agenda of the economic democratization.

## **3. RESTRUCTURING OF THE FINANCIAL SECTOR AND THE RESULTS**

The South Korea's financial system was deregulated at a rapid pace in the 1990s particularly under former President Kim Young Sam's policy of bringing the country into the Organization for Economic Cooperation and Development (OECD). In January 1992, the domestic stock market was first liberalized. To open the domestic financial markets and the financial industry to foreign competition in accordance with the "Third-Stage Program of the

Financial Autonomy and Liberalization” (June 1993), interest rates were liberalized in four stages from 1993. The deregulation of interest rates on all deposits other than ordinary deposits and financial products opened up the field for genuine competition among financial institutions.

In 1995, the South Korea adopted the “Bond Market Development Program” in order to strengthen the function of the bond market as a place to raise long-term funds. In line with the program, the South Korea abolished the system of adjusting bond issue amounts, maintained until then for interest rate stability, allowed interest rates on government bonds to reflect market conditions, and expanded the issuance of new types of bonds. The country also made other institutional changes to qualify as an OECD member, including changes in corporate accounting, changes to the payment settlement system, enhancement of the effectiveness of outside auditing, and improvement to the credit information management system<sup>1</sup>. The series of these hasty reform measures made it easy for corporate groups to raise funds and helped encourage their reckless investment.

Under the IMF’s terms of lending, the South Korean government was compelled to reorganize financial institutions swamped with nonperforming loans in a short period of time while at the same time helping strengthen the international competitiveness of surviving institutions. The first target chosen for the early normalization of the shaky financial markets was poorly managed financial institutions, including 14 merchant banks, which were deprived of their business licenses or ordered to suspend operations for liquidation. Under the framework of the financial structure reform of the fourth Corporate Restructuring Coordination Committee (CRCC) announced on April 14, 1998 (see Table 1-2), First Korea Bank and Seoul Bank were to be sold off to foreign financial institutions. The CRCC also urged 12 banks with the capital-assets ratio of less than 8% set under Bank for International Settlements (BIS) regulations to boost the capital base, requiring them to submit business normalization programs. On May 20, 1998, the sixth CRCC decided to inject a total of 64 trillion won of public funds into the financial system. The decision called on the government to raise 50 trillion won through bond issues, and allocated 9 trillion won of the funds raised for the protection of depositors, 16 trillion won for support of the banks, and 25 trillion won for the purchase of nonperforming loans by a loan-purchasing public corporation.

As planned, First Korea Bank was sold to Newbridge Capital of the United States. The mergers between Hana Bank and Boram Bank, and between Kookmin Bank and Korea Long Term Credit Bank were realized.

<sup>1</sup> Kyung Suh Park “Problems and Direction in Structural Reform regarding the Korean Financial System and Fund Raising by Korean Companies,” in *Takao Taniura (ed.) The South Korean Economy in the 21st Century: Problems and Prospects*, IDE-JETRO, 2000, p.54.

**Table 1-2 4th Corporate Restructuring Coordination Committee of April 14, 1998**

- (1) Government-held shares in bankrupt Seoul Bank and Korea First Bank should be sold off as soon as possible, notwithstanding the deadline (November 15, 1998) agreed with the IMF.
- (2) Move up the assessment of the management improvement programs of the 12 banks that failed to achieve the BIS-set capital-assets ratio of at least 8% from the originally set end-June 1998 in order to facilitate sound management of banks.
- (3) Securities companies and insurance firms should promote restructuring of non-deposit-taking financial institutions, including merchant banks, as responsible major shareholders of these companies.
- (4) Financial institutions should make self-help efforts to boost their capital bases by seeking to increase capital on their own by taking advantage of a revitalized stock market and by aggressively seeking direct foreign investment.
- (5) The CRCC decided to expand the funding resources of Deposit Insurance Corporation through such means as the contribution of state assets and increased bond issuance. It also decided to establish the Corporate Restructuring Fund of 10 trillion won to expand government support for the disposal of nonperforming loans and the protection of bank depositors.

Source: Prepared by the Author from the 4th Corporate Restructuring Coordination Committee of April 14, 1998.

As a result of the series of reorganization measures, the number of merchant banks was cut to only four in June 2001 from 30 at the end of 1997. The amount of nonperforming loans held by banks was reduced steadily to 88 trillion won in December 1999, to 76.3 trillion won in September 2000, to 64.6 trillion won in December 2000, and to 59.5 trillion won in March 2001.

The injection of public funds far exceeded the initially planned amount, reaching 153 trillion won by November 2001. The fund infusion continued to grow steadily in 2001, with banks still unable to regain stability of management.

#### **4. CORPORATE RESTRUCTURING AND THE RESULTS**

The South Korean government tightened the screws on the president of corporate groups, pressing them to carrying out corporate restructuring with the following as priority measures (see Table 1-3): (1) securing the transparency



**Table 1-3 Specific Items for Corporate Restructuring**

- (1) Transparency of corporate management
  - i. Publication of unified financial statements: broader than consolidated financial statements to cover companies under effective control
  - ii. Strengthening of minority shareholder rights: relaxation of requirements for the exercise of minority rights
  - iii. System of outside members of the board
  - iv. Mandatory external audit: strengthening of the function of monitoring over the execution of business affairs by the board, enhancement of investor confidence
- (2) Abolition of mutual payment guarantees: the plan to completely do away with debt guarantees among existing corporate group affiliates by March 2000. The business circles sought to convert mutual payment guarantees into equity participation.
- (3) Improvement of financial structure: the plan to lower the debt-equity ratio to 200% by 1999. The debt-equity ratio is on the decline due to equity capital increases, but this does not mean the decline in the absolute amounts of debts.
- (4) Focusing on core businesses (specialization): liquidation of affiliates in non-core businesses. Not a new policy. Business swaps: "Big deals" mapped out by the government involved the following industries: semiconductors, petrochemicals, automobiles, aircraft, rolling stock, power generation equipment, marine engines and oil refining. Failure to integrate Samsung Motor and Daewoo Motor. Problems at integrated chipmaker Hynix Semiconductor. Failure to merge Samsung Chemicals and Hyundai Petrochemical. In October 2001, Hyundai Petrochemical plunged into financial difficulties. The consortium of creditors agreed to convert loans worth 300 billion won into equity and reschedule debts totaling 1,700 billion won.
- (5) Strengthening of management accountability: Corporate group owners keep the firm grip on corporate management despite surprisingly low equity ownership ratios. Owners should assume the post of chief executive in order to make clear their responsibility for corporate management.

- (6) Separation of industrial capital and financial capital (the exchange listing of life insurance firms and other financial institutions not publicly traded).
- (7) Curbs on circular equity investment and abolition of unreasonable in-house transactions.
- (8) Halt to patrimony of management rights through unusual inheritance and donation.

Source: Prepared by the Author from "Structural Reform of Korean Chaebol under the Kim Dae-Jung Regime," by Shin'ichi Nozoe in Takao Taniura (ed.) *op. cit.*

of corporate activities, with the requirement to prepare consolidated financial statements; (2) abolishing the practice of mutual debt guarantees and raising the self-owned capital ratios; (3) improving the financial structure; (4) consolidation and specialization of businesses; and (5) strengthening management accountability. Regarding (4) consolidation and specialization of businesses, in particular, the government called for bank-coordinated business swaps among the five biggest corporate groups.

On September 8, the Federation of Korean Industries announced the "Consideration of Measures for the Promotion of Business Restructuring," calling for business swaps and reorganization in seven specific industries. The industry sectors cited are (1) semiconductors; (2) petrochemicals; (3) aircraft; (4) rolling stock; (5) power generation equipment; (6) marine engines; and (7) oil refining. For (1) semiconductors, the federation said Hyundai Electronics Co. and LG Semicon were in consultations on the merger ratio. While Hyundai Electronics wanted to absorb LG Semicon, LG Semicon was offended by the politically motivated merger proposal. The rift deepened between the two corporate groups involved. In (2) the petrochemical sector, the plan called for the integration of Hyundai Petrochemical and Samsung General Chemical, and then foreign capital participation in the integrated entity. In (3) aircraft, the introduction of foreign capital was also sought following a merger of three companies of the Hyundai, Samsung and Daewoo groups. For (4) rolling stock, three companies of the Hyundai, Daewoo and Hanjin groups were to be integrated before inviting a foreign-capital partner. In the area of (5) power generators, the restructuring plan called for the Samsung group's boiler division to be transferred to Hankook Heavy Industries, whose power generation equipment business was then to be integrated with that of Hyundai Heavy Industries. For (6) engines for ships, Samsung was to transfer its engine facility to Hankook Heavy Industries. In (7) oil refining, Hyundai was to take over Hanwha Chemical's refining division. What became of these restructuring plans was summarized in Table 1-4.

**Table 1-4 “Big Deals” in 7-Plus Industries**

Federation of Korean Industries announced big deals among the 5 major business groups on September 3, 1998.

Industry	Plan	as of end-1999	as of end-2000	2001
(1) Semiconduc- tors	Hyundai Electronic, LG Semicon to merge	LG sells 59% equity stake in LG Semicon to Hyundai, new firm renamed Hynix Semi- conductor		Hynix goes into deficit, sell off some facilities, gets bank support
(2) Petrochemi- cals	Samsung General Chemical, Hyundai Petrochemical to be inte- grated, invite a foreign partner	Samsung General Chemicals signs contract to sell air- separation facilities in the Daesan industrial park to BOC of U.K. In April 1999	2 firms give up an integra- tion plan	Hyundai Petrochemical slips into difficulties, gets financial support
	personnel cuts of 20%	Hyundai Petrochemical sells of part of production facilities		
(3) Aircraft	Hyundai Space & Aeroplane Samsung Techwin, Daewoo Heavy Industries to merge, invite foreign capital participation later	Hyundai Space & Aeroplane Samsung Techwin, Daewoo Heavy Industries conclude talks on setting up an integrated entity		
	personnel cuts of 10~15%			

(continued)

Industry	Plan	as of end-1999	as of end-2000	2001
(4) Rolling stock	Hyundai Precision, Daewoo Heavy Industries, Hanjin Heavy Industries to merge, invite foreign capital later  personnel cuts of 10~20%	After the 3- way merger, the integrated entity inaugurated as Korea Rail Car		
(5) Power generation equipmen	Hyundai Heavy Industries, Hankook Heavy Industries to integrate their power generation equipment divisions	Samsung Heavy Industries transfers power generation equipment division to Hankook Heavy Industries; Hyundai Heavy Industries hands over control of the integrated entity to Hankook Heavy Industries		

(continued)

Industry	Plan	as of end-1999	as of end-2000	2001
(6) Marine engines	Samsung transfers production facilities for marine engines and boilers to Hankook Heavy Industries	Samsung Heavy Industries transfers marine engine division to Hankook Heavy Industries; Hankook Heavy Industries spins it off as a separate entity		
(7) Oil refining	Hyundai to take over Hanwha Chemical's oil refining division, then invite a foreign partner	Hyundai settles talks on takeover of Hanwha's oil refining division		
(*) Automobiles	Hyundai Motor to absorb Kia Motors		Kia Motors freed from legal receivership	
	Samsung Motors to be swapped for Daewoo Electronics	Samsung Motors goes bankrupt	Renault SA of France buys out Samsung Motors, launches Renault-Samsung Motors	

(continued)

Industry	Plan	as of end-1999	as of end-2000	2001
(*) Steel	Kangwon Industries, Inchon Iron & Steel to merge	Kangwon Industries, Inchon Iron and Steel merged to become world's 2nd biggest electric-furnace steelmaker		
	Sammi Steel to sell the specialty steel division in Changwon to Pohang Iron and Steel, the division to be made into a separate unit called Changwon Steel	Sammi Steel sold to Inchon Iron & Steel, but normalized in March 2001 under the corporate rehabilitation law		
		Bankrupt Kia Steel merged with Changwon Steel after specialization in carbon steel, alloy steel		
	Bankrupt Hanbo Steel Industries to be sold to U.S. Investment firm Neighbors Consortium	Sale of bankrupt Hanbo Steel Industries fall through		

(continued)

Industry	Plan	as of end-1999	as of end-2000	2001
		Pohan Iron and Steel proposes cross-shareholdings to Nippon Steel; Kawasaki Steel purchases equity shares in Dongkuk Steel Mill	Kawasaki Steel invests in Hyundai Pipe	

Source: Prepared by the author.

## 5. REFORM OF THE LABOR MARKET AND IMPROVEMENT OF SOCIAL SECURITY

At the fifth CRCC meeting on January 14, the decision was made to revise laws on labor relations to ensure mobility of the labor market and flexibility in employment as part of the efforts to carry out the accords with the IMF, which called for greater mobility of labor, introduction of the system of temporary staffing dispatching, and improvement of the employment insurance scheme.

At the committee of representatives from labor, management and the government on February 6, an agreement was reached for an early introduction of the corporate reorganization dismissal system. For the dismissal of workers, the accord set forth the following conditions and requirements: (1) managerial necessity for emergency steps; (2) management efforts to avoid dismissals; (3) rational and fair selection of workers to be dismissed; (4) consultations with representatives of workers 60 days prior to the dismissals; and (5) prior notice to the government.

For the improvement employment insurance scheme, the CRCC decided to revise the employment insurance law in an extraordinary session of the National Assembly in February to ease qualifications to receive unemployment benefits and extend the minimum period of benefits payments from 30 days to 60 days.

The assembly was called into extra sitting on February 2. On February 14, the assembly approved a bill to revise the labor relations law, introducing the system of worker dismissals for corporate restructuring, the thorniest of the proposed labor market reforms.

## **6. SELECTION AND GROWTH OF COMPANIES**

After going through the currency crisis, the South Korean economy got back on a track of high growth from 1999, posting the growth rate of 10.9% in 1999 and 8.8% in 2000. The decline of its currency, the won, helped boost international price competitiveness of the South Korean exports, and companies, with their heavy debts frozen, resumed active equipment investment. Also significantly contributing to the resumption of economic growth was the reduced burden on South Korean companies after they went through the selection process, including the sale of assets to foreign investors.